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DIVISION OF
TRADING & MARKETS

INFORMATIONAL MEMORANDUM

COMMENT

TO: The Commission

FROM: Division of Trading and Markets *JL*

DATE: June 9, 2000

RE: Summary of Comments on Proposed Revisions to Rule 4.7

On March 2, 2000, the Commission proposed revisions to Rule 4.7. 65 Fed. Reg. 11253.

Attached is a Summary of Comments on the proposal. If you have any questions on the Summary, please contact Barbara Gold or Helene Schroeder at x5450.

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**SUMMARY OF COMMENTS ON
PROPOSED REVISIONS TO RULE 4.7**

**65 Fed. Reg. 11253
(March 2, 2000)**

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EXPLANATORY NOTE

Rule 4.7 provides a simplified regulatory framework for commodity pool operators (“CPOs”) operating commodity pools consisting of, among other persons, certain highly sophisticated or accredited pool participants termed “qualified eligible participants” (“QEPs”) and for commodity trading advisors (“CTAs”) directing or ~~guiding the commodity interest trading accounts of certain highly sophisticated or~~ accredited clients, termed “qualified eligible clients (“QECs”).

On March 2, 2000, the Commission published for comment in the *Federal Register* proposed revisions to Rule 4.7 (the “Proposal”). 65 Fed. Reg. 11253. Certain proposed revisions would amend the rule substantively, by defining more persons as QEPs and QECs. Other proposed revisions would amend the rule technically, by reorganizing the current structure to facilitate determinations of whether a person is (or is not) a QEP or a QEC. Still other proposed revisions would conform various references in the existing rule to those in the proposed rule. The comment period on the Proposal expired May 1, 2000.

The Commission received six comment letters on the Proposal (although, as is discussed below at Item 7 of the text of this Summary, not all of the comments were directly related to the Proposal), as follows: one from a firm registered as a futures commission merchant, CPO and CTA; one from a firm registered as a CPO; one from a designated self-regulatory organization; one from a bar association; one from a

member of the commodities bar; and one from a trade association representing CPOs and CTAs.

For purposes of this Summary, the comments were edited for brevity and clarity, although as much as possible of the commenters' own language was retained. To avoid the unnecessary repetition of substantially identical comments, and to show the extent of agreement between and among commenters on a particular issue, this Summary uses the term *accord* where commenters had markedly similar views and *see also* where commenters expressed related views.

Finally, it should be noted that for each proposed revision on which the Commission received comments, this Summary includes: (A) the text of the proposed revision; and (B) comments received on the proposed revision.

ABBREVIATION KEY

| Name of Commenter | Abbreviation |
|--|---------------------|
| Association of the Bar of the City of New York | NYBar |
| Sanford C. Bernstein & Co., Inc. | Bernstein |
| Phillip McBride Johnson | Johnson |
| Managed Funds Association | MFA |
| National Futures Association | NFA |
| D. E. Shaw & Co., LP | DESCO |

SUMMARY OF COMMENTS

1. *General Comments.*

All of the persons who commented on the Proposal expressed strong support for the Proposal.¹ Among the reasons commenters provided for their support were that the Proposal: (1) would coordinate and harmonize the commodities and securities laws where they have a common purpose (**Bernstein; accord, MFA; NYBar**); (2) would relieve Commission staff from expending its resources on what have become routine and redundant relief letters (**DESCO; accord, MFA; NYBar**); (3) would provide similar relief to the applicants for those letters (**DESCO**); and (4) would make the rules more “user friendly” (**DESCO; see also NYBar**).

2. *Proposed Rule 4.7(a)(1)(iv)(D): Reorganization of the definition of the term “Non-United States person.”*

A. Text

(a) *Definitions.*

(1) * * *

(iv) *Non-United States person* means:

* * * * *

(D) An entity organized principally for passive investment such as a pool, investment company or other similar entity; *Provided*, That units of participation in the entity held by persons who do not qualify as Non-United States persons represent in the aggregate less than 10% of the beneficial interest in the entity, and that such entity was not formed principally for the purpose of facilitating investment by persons who do not qualify as Non-United

¹ As stated above in the Explanatory Note, not all of the comments received in connection with this rulemaking specifically addressed proposed revisions to Rule 4.7. Those comments are presented at Item 7 below.

States persons in a pool with respect to which the operator is exempt from certain requirements of Part 4 of the Commission's regulations by virtue of its participants being Non-United States persons; . . .

B. Comments

DESCO commented that it was unclear how, if at all, the 10% restriction on United States persons would affect the definition of "an entity in which all of the unit owners or participants" as a QEP. (See existing Rule 4.7(a)(1)(ii)(C), proposed Rule 4.7(a)(2)(i)(L)). It recommended that the rule should make clear that United States persons who are QEPs are not counted toward the 10% restriction.

3. *Proposed Rule 4.7(a)(1)(v): Reorganization of the term "Portfolio Requirement."*

A. Text

(a) *Definitions.*

(1) * * *

(v) *Portfolio Requirement* means:

(A) With respect to a qualified eligible participant, that the person:

(1) Owns securities (including pool participations) of issuers not affiliated with such participant and other investments with an aggregate market value of at least \$2,000,000;

(2) Has had on deposit with a futures commission merchant, for its own account at any time during the six-month period preceding the date of sale to that person of a pool participation in the exempt pool, at least \$200,000 in exchange-specified initial margin and option premiums for commodity interest transactions; or

(3) Owns a portfolio comprised of a combination of the funds or property specified in paragraphs (a)(1)(v)(A)(1) and (2) of this section in which the sum of the funds or property includable under paragraph (a)(1)(v)(A)(1), expressed as a percentage of the minimum amount required thereunder, and the amount of futures margin

and option premiums includable under paragraph (a)(1)(v)(A)(2), expressed as a percentage of the minimum amount required thereunder, equals at least one hundred percent. An example of a composite portfolio acceptable under this paragraph (a)(1)(v)(A)(3) would consist of \$1,000,000 in securities and other property (50% of paragraph (a)(1)(v)(A)(1)) and \$100,000 in exchange-specified initial margin and option premiums (50% of paragraph (a)(1)(v)(A)(2)).

(B) With respect to a qualified eligible client, that the person:

(1) Owns securities (including pool participations) of issuers not affiliated with such client and other investments with an aggregate market value of at least \$2,000,000;

(2) Has had on deposit with a futures commission merchant, for its own account at any time during the six-month period preceding the date that person opens an exempt account with the commodity trading advisor, at least \$200,000 in exchange-specified initial margin and option premiums for commodity interest transactions; or

(3) Owns a portfolio comprised of a combination of the funds or property specified in paragraphs (a)(1)(v)(B)(1) and (2) of this section in which the sum of the funds or property includable under paragraph (a)(1)(v)(B)(1), expressed as a percentage of the minimum amount required thereunder, and the amount of futures margin and option premiums includable in paragraph (a)(1)(v)(B)(2), expressed as a percentage of the minimum amount required thereunder, equals at least one hundred percent. An example of a composite portfolio acceptable under this paragraph (a)(1)(v)(B)(3) would consist of \$1,000,000 in securities and other property (50% of paragraph (a)(1)(v)(B)(1)) and \$100,000 in exchange-specified initial margin and option premiums (50% of paragraph (a)(1)(v)(B)(2)).

B. Comments

NFA questioned the need for two separate definitions of *Portfolio*

Requirement because, as it pointed out, these definitions are virtually identical except

for two references in the current rules where the definition applicable to QEPs concerns “pool participants” and the definition applicable to QECs concerns “clients.” NFA accordingly recommended that the Commission should merge the two *Portfolio Requirement* definitions into one definition.

4. *Proposed Rules 4.7(a)(2)(i) and 4.7(a)(3)(i): Requirement that a CPO or a CTA have a reasonable belief in each case that a prospective pool participant or client is a QEP or a QEC, respectively.*

A. Text

(a) *Definitions.*

* * * * *

(2) *Qualified eligible participants.*

(i) *Persons who are qualified eligible participants irrespective of the Portfolio Requirement. Qualified eligible participant* means any person, acting for its own account or for the account of a qualified eligible participant, who the commodity pool operator reasonably believes, at the time of the sale to that person of a pool participation in the exempt pool, is:

* * * * *

(3) *Qualified eligible clients.*

(i) *Persons who are qualified eligible clients irrespective of the Portfolio Requirement. Qualified eligible client* means any person, acting for its own account or for the account of a qualified eligible client, who the commodity trading advisor reasonably believes, at the time that person opens an exempt account with the commodity trading advisor, is:

B. Comments

Several commenters stated that they had no objection to this standard. MFA; NYBar. DESCO, however, stated that it had no objection to this standard *provided*

that the CPO or CTA have latitude in determining how to obtain a “reasonable belief” – whether by statements by the prospective investor, its agent or other similar means.

5. *Proposed Rules 4.7(a)(2)(i)(H) and 4.7(a)(3)(i)(B): Including “Insiders” and Certain Immediate Family Members as QEPs and QECs.*

A. Text

~~(a) Definitions.~~

* * * * *

(2) *Qualified eligible participants.*

(i) * * *

* * * * *

(H)(1) The commodity pool operator, commodity trading advisor or investment adviser of the exempt pool offered or sold, or an affiliate of any of the foregoing;

(2) A principal of the exempt pool or the commodity pool operator, commodity trading advisor or investment adviser of the exempt pool, or of an affiliate of any of the foregoing;

(3) An employee of the exempt pool, commodity pool operator, commodity trading advisor or investment adviser of the exempt pool, or of an affiliate of any of the foregoing (other than an employee performing solely clerical, secretarial or administrative functions with regard to such person or its investments) who, in connection with his or her regular functions or duties, participates in the investment activities of the exempt pool, other commodity pools operated by the commodity pool operator of the exempt pool or other accounts advised by the commodity trading advisor or the investment adviser of the exempt pool, or by the affiliate; *Provided*, That such employee has been performing such functions and duties for or on behalf of the exempt pool, commodity pool operator, commodity trading advisor, investment adviser or affiliate, or substantially similar functions or duties for or on behalf of another person engaged in providing commodity interest, securities or other financial services, for at least 12 months;

(4) Any other employee of the exempt pool, commodity pool operator, commodity trading advisor or investment adviser of the exempt pool, or of an affiliate of any of the foregoing (other than an employee performing solely clerical, secretarial or administrative functions with regard to such person or its investments); *Provided*, That such employee:

(i) is an accredited investor as defined in § 230.501(a)(5) or (6) of this title; and

(ii) has been employed by the exempt pool, commodity pool operator, commodity trading advisor, investment adviser or affiliate, or by another person engaged in providing commodity interest, securities or other financial services, for at least 24 months; or

(5) The spouse, child, sibling or parent of a person who satisfies the criteria of paragraph (a)(2)(i)(H)(I), (2), (3) or (4) of this section; *Provided*, That:

(i) an investment in the exempt pool by any such family member is made with the knowledge and at the direction of the person; and

(ii) the family member is a qualified eligible participant only for the purposes of this paragraph (a)(2)(i)(H)(5);

* * * * *

(3) *Qualified eligible clients.*

(i) * * *

* * * * *

(B)(I) An affiliate of the commodity trading advisor of the exempt account;

(2) A principal of the commodity trading advisor of the exempt account or of an affiliate of the trading advisor;

(3) An employee of the commodity trading advisor of the exempt account or of an affiliate of the trading advisor (other than an employee performing solely clerical, secretarial or administrative functions with regard to such person or its investments) who, in connection with his or her regular functions or duties, participates in the investment activities of the commodity trading advisor or the affiliate; *Provided*, That such employee has been performing such functions and duties for or on behalf of the commodity trading advisor or the affiliate, or substantially similar functions or duties for or on behalf of another person engaged in providing

commodity interest, securities or other financial services, for at least 12 months;

(4) Any other employee of the commodity trading advisor of the exempt account or of an affiliate of the trading advisor (other than an employee performing solely clerical, secretarial or administrative functions with regard to such person or its investments); *Provided*, That such employee:

(i) is an accredited investor as defined in § 230.501(a)(5) or (6) of this title; and

~~(ii) has been employed by the commodity trading advisor or the affiliate, or by another person engaged in providing commodity interest, securities or other financial services, for at least 24 months; or~~

(5) The spouse, child, sibling or parent of the commodity trading advisor of the exempt account or of a person who satisfies the criteria of paragraph (a)(3)(i)(B)(1), (2), (3) or (4) of this section; *Provided*, That:

(i) the establishment of an exempt account by any such family member is made with the knowledge and at the direction of the trading advisor or person; and

(ii) the family member is a qualified eligible client only for the purposes of this paragraph (a)(3)(i)(B)(5);

B. Comments

DESCO noted that Investment Company Act Rule 3c-5, which defines “knowledgeable employees,” also includes transferees by gift or bequest but the Commission’s proposed rules do not. It recommended that Rule 4.7 similarly should provide that transferees by gift or bequest by “insiders” should themselves be treated as QEPs and QECs.

NYBar questioned the exclusion of certain attorneys and other appropriate professionals from these additional QEP and QEC categories. It expressed the view that attorneys who are familiar with these types of products from the preparation of

Disclosure Documents and other materials would possess a higher degree of sophistication and information about them than many family members. Thus, it recommended that the Commission should consider, at a minimum, including as QEPs and QECs attorneys who supervise Disclosure Document preparation, and perhaps other professionals whose role and familiarity, along with the products, in the judgment of the Commission, merit that classification.

DESCO also commented that the limitation on family members being treated as QEPs (proposed Rule 4.7(a)(2)(i)(H)(5)) or QECs (proposed Rule 4.7(a)(3)(i)(H)(5)) is unnecessarily opaque. It stated that a family member of a QEP or a QEC should be considered a QEP or a QEC for all purposes of the rule – *e.g.*, for the purposes of determining whether an entity seeking QEP status is owned entirely by QEPs (and thus itself would be a QEP under existing Rule 4.7(a)(1)(ii)(D) and proposed Rule 4.7(a)(2)(i)(L)).

6. *Proposed Rule 4.7(a)(3)(i)(A)(2): Including Non-United States persons as QECs under certain circumstances.*

A. Text

(a) *Definitions.*

* * * * *

(3) *Qualified eligible clients.*

(i) * * *

(A) * * *

(2) A person described in paragraph (a)(2)(i)(K) of this section [*i.e.*, a Non-United States person]; *Provided*, That the CTA who seeks to direct or guide the commodity interest trading account of the person:

- (i) Provides commodity interest trading advice exclusively to persons who are qualified eligible clients, including persons described in paragraph (a)(2)(i)(K) of this section; and
- (ii) Has filed a notice of claim for exemption pursuant to paragraph (c) of this section;

B. Comments

Commenters on this proposed revision expressed the view that relief in this area should be expanded but that the Commission had not gone far enough. **DESCO; NFA; MFA; NYBar.**

The limitations on the availability of a CTA treating a Non-United States person were criticized for a variety of reasons. Some commenters stated that the proposed rule would vary the availability of relief under Rule 4.7 depending upon the activities involved in offering the program rather than on the qualifications or characteristics of a potential managed account client. They accordingly objected to the proposed limitation on permitting CTAs to claim relief under Rule 4.7 where it has both United States and Non-United States persons as clients. **NYBar; accord, MFA; see also, NFA.**

These commenters further contended that the result of the proposed limitation would be that the same client choosing to do business with two different CTAs might receive disclosure in one case but not the other, simply because of variations in the manner in which the CTA markets itself to different investors. They claimed that the focus of the regulatory requirement should be on the nature of the investor, rather

than on the manner in which the CTA chooses to conduct its business. **NYBar**; *accord*, **MFA**; **NFA**.

Commenters also disagreed with the Commission's argument that this framework would not impose any additional burdens on the CTAs because they would already be subject to disclosure and recordkeeping requirements with regard to their (other) Non-QEC clients. **DESCO**; **NFA**. One of these commenters further stated that while this may be true where the trading programs and solicitation documents are substantially the same, this frequently will impose a significant burden on CTAs where the trading programs and solicitation documents are different – thereby requiring significant additional work for the CTA in what is likely to be a very different context. **DESCO**.

In support of permitting CTAs to treat Non-United States persons as QECs without limitation, commenters noted that a CTA soliciting Non-United States persons is subject to the requirements of applicable foreign law, including any mandatory disclosure requirements. **NYBar**; *see also* **MFA**. Also, it was claimed that foreign regulators are uniquely suited to creating and enforcing laws to protect their citizens. **NYBar**.

Moreover, from an overall framework approach, commenters saw no reason why a Non-United States person should be treated differently depending on whether it is dealing with a CPO or a CTA. **NFA**; *accord*, **MFA**.

Thus, commenters on this proposed provision uniformly concluded that the Commission should simplify the regulation of this area by treating Non-United States persons as QEPs and QECs in all situations. **NFA**; *accord*, **DESCO**; **MFA**; **NYBar**. One commenter did state, however, that *if* the proposed limitation were to be retained at all, it should be limited to those cases where the CTA is employing substantially the same trading program for Non-United States persons and Non-QECs. **DESCO**.

7. Other Comments.

NFA commented that the Commission's regulations (Rules 1.3, 1.55, 4.7, 35.1 and 36.1) could be simplified even further by adopting the uniform definition of sophisticated customer set forth in our June 1999 Petition for Rulemaking. *Accord*, **MFA**.

MFA suggested that the Commission also should consider further harmonizing the Act with federal securities laws by considering an exemption from CPO registration for operators of privately offered investment entities limited solely to Non-United States persons, claiming that under both the Securities Act of 1933 and the Investment Company Act of 1940, such entities have long been considered outside the scope of necessary U.S. regulatory oversight. Currently, potential Non-United States investors in offshore pools operated by registered CPOs are in many instances reluctant to participate in such pools because of the record-keeping requirements of Rule 4.23. At a minimum, then, the Commission should exempt CPOs with no United States participants in their pools from the recordkeeping

requirements of Rule 4.23 in order to make those pools more attractive to Non-United States investors.

Johnson recommended that the Commission further should adopt regulations to the effect that a collective investment vehicle using commodity interests solely for recognized risk management purposes is not a commodity pool.